Economic and political roundup

Investment companies | Monthly | July 2023

Picking up from where they left off in May, US markets continued to surge ahead in June, comfortably outperforming their global peers. The return to US dominance has been well documented, particularly regarding index concentration, with the top seven companies on the NASDAQ 100 adding one entire Germany worth of market cap over the first six months of the year.

Along with the AI binge, large cap tech has benefited from the relative safety provided by established, secular cashflows and unparalleled balance sheet strength which appears to have insulated the sector from continually rising discount rates. Still, with earnings steadily turning over, it's difficult to see how such rich multiples, which have returned to the highs reached during the peak of the post pandemic rally, can be maintained.

***"When we have free money people do stupid things. When we have free money for a decade people do very stupid things"* - Stanley Druckenmiller**

Outside of the US, markets have struggled. Inflation continues to torment policy makers in the UK, while the Eurozone is faced with a diverging landscape where pricing pressures have receded in some locales while remaining red hot in others. It remains unclear how the ECB plans to manage such a scenario with one overarching monetary policy regime.

In China, things have gone from bad to worse as optimism around the reopening gave way to a raft of geopolitical and economic concerns. The economy continues to battle tepid domestic demand, credit growth, and a global slowdown in trade while efforts to stimulate risk exacerbating a deeply complex and already overleveraged property sector.

Somewhat surprisingly, emerging markets provided a silver lining for the month, with Latin America and India leading the way, providing a bastion of strength relative to their more established peers.

The top seven companies on the NASDAQ 100 have added one entire Germany worth of market cap over the first six months of the year.

Despite the market declines in 2022 in equities and bonds, valuations remain high as investors are anchored on multiples of the last decade

In terms of the long-term potential of UK equities, we suggest that investors willing to look beyond the ongoing negative headlines will find the UK punches above its weight.

QuotedData
BY MARTEN & CO

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At a glance

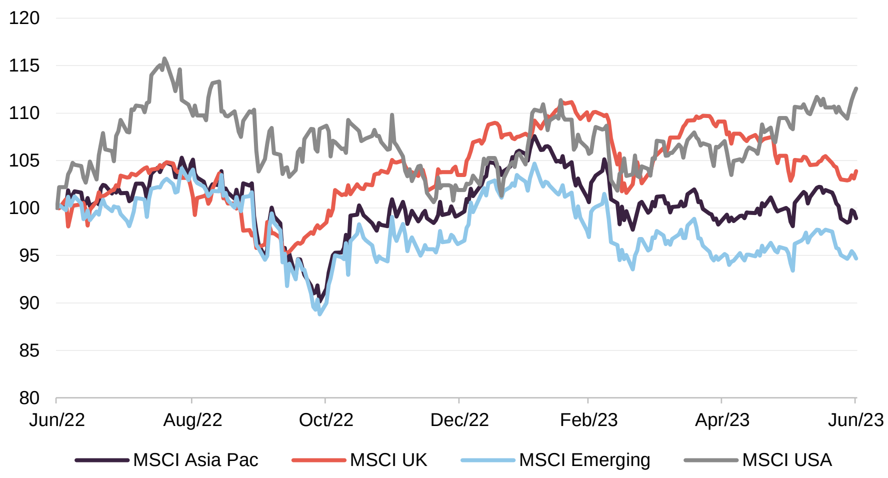
Exchange rate		30/06/23	Change on month %
Pound to US dollars	GBP / USD	1.2703	2.1
US dollars to Euros	USD / EUR	0.9167	(2.0)
US dollars to Japanese yen	USD / JPY	144.31	3.6
US dollars to Swiss francs	USD / CHF	0.8956	(1.7)
US dollars to Chinese renminbi	USD / CNY	7.2537	2.0

Source: Bloomberg, QuotedData

MSCI Indices (rebased to 100)

Economic resilience and AI exuberance has continued to drive a gap between the US and other developed markets. Meanwhile, the UK and Europe's inflation battle remains ongoing. Weakness out of China acted as a drag to EM markets in June, however the region's performance has been encouraging on the whole. Investors have piled into Latin American funds in particular, attracted by high real yields and an unexpectedly resilient economy, with the region now supporting five of the world's top eight performing currencies.

Time period 30 June 2022 to 30 June 2023



Source: Morningstar, QuotedData. Converted to pounds to give returns for a UK-based investor.

Indicator	30/06/23	Change on month %
Oil (Brent – US$ per barrel)	72.66	(8.4)
Gold (US$ per Troy ounce)	1962.73	(1.0)
US Treasuries 10-year yield	3.64	2.1
UK Gilts 10-year yield	4.18	12.5
German government bonds (Bunds) 10-year yield	2.28	(1.3)

Source: Morningstar, QuotedData

Global

(compare global and flexible investment funds **here, here, here** and **here**)

John Scott, chairman, JPMorgan Global Core Real Assets - 29 June 2023

The current environment is both at the political and macro level one of the most uncertain in the last decade, if not since the global financial crisis of 2008/09. The public capital markets have adjusted rapidly to the increase in central bank rates and monetary tightening; the private markets have begun this process, but the market has been and will continue to go through a process of price discovery as views on the trajectory of inflation and rate movements become clearer and therefore allow both buyers and sellers to focus on what is an acceptable range of pricing.

There remains a significant appetite for new capital, not least in the area of decarbonising our energy cycle, notably the substitution of wind, solar and nuclear electricity for fossil fuelled generation. Global, secular trends such as the drive to net zero and increasing digitisation of industry and consumer experience, will be long term asset growth drivers.

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Alex Crooke, fund manager, Bankers Investment Trust - 12 June 2023

Tighter monetary conditions, driven by increasing interest rates and bond sales from central banks, have a dampening effect on economic activity. However, the real economy is actually weathering these conditions well, with many companies having low levels of debt and possessing pricing power, while consumers are benefitting from wage growth or using savings to bolster spending. However, the rate of inflation needs to fall. The alternative is that interest rates will continue to rise or be maintained at a high level for longer and their impact will be felt more deeply by many. There is good evidence that prices are starting to moderate and, in the case of energy, starting to fall. We expect markets in Asia to lead the recovery and are positioned for better news in that region. However, we remain more cautious in other regions.

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Sebastian Lyon, investment manager, Personal Assets Trust - 12 June 2023

The past two years have seen us exit a hall of mirrors. We are now emerging from a prolonged period of distortion, born of zero (and even negative) interest rates, combined with quantitative easing. Economies and financial markets are slowly absorbing the effects of much tighter monetary conditions. While the dominos have been falling since early 2021, with the peaking-out of cryptocurrencies and retail investor speculation, the process of unwinding excess will take time and requires patience. The consequences are the unravelling of the 'Everything Bubble', which has inflated all assets and is likely to end with prices falling back down to earth.

Despite the market declines in 2022 in equities and bonds, valuations remain high as investors are anchored on multiples of the last decade.

We are no longer in a buy-and-hold market, in which valuations expand as lower yields support higher prices. We expect that inflation has become embedded. This is the product of several factors, but of particular importance is the increased bargaining power of labour in the aftermath of the pandemic. Wage inflation is the most important component in driving higher prices on a more sustained basis. This is coinciding with slowing globalisation and increased intervention from governments, often in pursuit of more nationalist agendas. These factors are inflationary, and they come at a time when central banks have less room to manoeuvre. We expect that interest rates can only rise so far without severely injuring indebted economies. This unfamiliar backdrop has called time on a 40-year bull market in bonds, with all the implications that brings for investors.

The beneficiaries of four decades of falling yields are less likely to perform in this new regime. We are looking for companies that will learn to thrive in the new environment. As Edward Chancellor's excellent book *The Price of Time* informs us, the 2010s may look like an aberration, a product of highly unusual conditions where ultra-low interest rates prevailed. The past environment rewarded insensitivity to valuation and the purchase of growth at any price. Such a strategy is less likely to succeed in the 2020s. Higher costs of debt are only just beginning to be felt. In any normal cycle, there is usually a lag before Federal Reserve rate rises take effect and the lag may be longer this time around. This is largely on account of consumer resilience, a product of transfer payments and consumer savings that were built up during the pandemic and are still being run down. Those will not last forever, but they might provide a stay of execution until 2024. In addition to this, much of today's finance is in the shadows in the form of private equity and leveraged loans, which have ballooned in a post-financial crisis economy. Private equity investors find themselves in a Faustian pact with their managers, resisting the need to mark down their investments. Write-downs may be delayed but not avoided. In the world of private equity, price discovery is inevitably more opaque for both the managers and the owners but its effects will ultimately be felt.

American investor Stanley Druckenmiller said recently, *"when we have free money people do stupid things. When we have free money for a decade people do very stupid things"*. These are now being revealed. The collapse of Silicon Valley Bank in March, along with Credit Suisse, Signature Bank and more recently First Republic, exposes vulnerabilities to the fastest tightening of interest rates in 40 years. We are beginning to see the unfolding of a regional banking crisis in the United States. The environment for borrowing has become a lot tougher, and this will affect consumers and businesses alike. With inflation elevated, central banks cannot be seen to pivot too early. We expect that this necessitates a 'hard landing' when it comes to the real economy, something that is not currently being factored into equity valuations. Our low equity exposure at c.24%, which is a 10-year low, reflects this.

We have been hunkering down since 2021 in the knowledge that a prolonged bull market is likely to be followed by a painful bear market. Our liquidity remains high, yet sharp-eyed shareholders will notice a very low level of actual cash. We are at last paid to wait, with short dated UK gilts and US Treasuries yielding 4 to 5%. 2022 was the year we shifted from TINA (there is no alternative to equities) to TARA (there is a real alternative). A risk-free rate substantially above zero is back, for the first time since 2008. Most of our stocks have been defensive in the past year, with the share price of companies held in the portfolio appreciating +4% on average in sterling. We are delighted to see our staples such as Nestlé, Procter & Gamble and Unilever demonstrating excellent pricing power without sacrificing volumes. Portfolio activity was higher in the first half of the financial year but remained modest in the second half of the period.

Gold has performed well and is currently flirting with a new all-time high in US dollar terms. Performance from bullion, in an environment of weaker sterling, has been helpful to the Company. Gold, for us, remains essential portfolio insurance and a diversifier from risk assets. It also provides valuable protection against the ongoing debasement of fiat currencies. A recession is likely to unleash more money printing down the line. This will be positive for the currency that cannot be printed.

After a disappointing year in 2022, we believe that index-linked bonds are now poised for better returns. In the US, index-linked bonds are trading on positive real yields, and we believe that their (currently depressed) valuation offers two ways to win. The first will be if nominal bond yields fall, returning from whence they came. This will occur if interest rates are cut, as they were in 2008 or 2020, in response to a struggling economy. Alternatively, inflation expectations rising will lift 'breakevens' (the inflation rate priced into bond markets) as investors anticipate inflation to return on a more structural basis. As it stands, index-linked bonds are pricing in a world where interest rates remain higher than they have been in over a decade, but where inflation returns to the Federal Reserve's 2% target. In such a world, real growth needs to be structurally stronger than it has been. For the reasons alluded to in this report, namely the continued indebtedness of Western economies and the recent rise in the cost of capital, we do not believe this to be consistent with the likely reality.

In light of all of this, investors are talking bearishly. But they are acting bullishly. It will take time for positioning to shift from the benign environment of the past decade. Investor focus seems to be on coincident indicators as opposed to looking forward to the effects of higher interest rates and tighter lending conditions. These are likely to lead to a recession. Bond markets, often a more reliable and rational indicator than more emotional and volatile stock markets, are indicating the most inverted yield curve since 1981. The lower yields in longer duration bonds are a clear warning of a hard landing. This is currently being ignored. Ayrton Senna said, *"You cannot overtake 15 cars when it's sunny…but you can when it's raining*". We know the companies we want to own should attractive valuation opportunities present themselves and we are ready to increase our equity exposure, from currently prudent levels, as conditions become more treacherous.

John Evans, chairman, STS Global Income & Growth Trust - 8 June 2023

Much of the focus of financial markets is on the timing and scale of changes in short term interest rates. We may be near the peak of the current cycle - there are a myriad of views. However, whilst the cost of debt may change it is unlikely that Central Banks will relent on their liquidity policies as these have to address 14 years of largesse. Many of the well-publicised issues in the US and other banking systems recently owe more to the effects of the quantitative tightening than the higher cost of money.

The rate of inflation may be declining, or be forecast to do so, but prices are still rising at unfamiliar levels.

Managers, Edinburgh Worldwide - 8 June 2023

Some Reflections on Growth and Technology

We have frequently noted how innovation and the application of technology is a structural force that largely sits outside of conventional business cyclicality. But recent headlines on technology sector job losses and retrenchment indicate that many tech-led companies have not been immune from current pressures. In some cases, the reasons for this cyclicality directly relate to end product demand, but in many other areas we suspect it represents a period of adaption to a new normal that we would ultimately expect to see replicated more broadly across the economy.

That 'new normal' will likely favour efficiency in pursuing business growth. In an era of zero-cost money, a surplus of labour and an economic tailwind, the issue of productivity was primarily addressed indirectly through the expansionary pursuit of scale: grow bigger and operational leverage would ultimately drive productivity. Direct investments in productivity tools to drive unit economic efficiencies were generally less popular as they were less likely to yield near-term expansionary growth. Furthermore, they often carried a risk of disrupting an organisation as old processes and workflows are ripped and replaced.

We sense that the broad premise of technology adaptation sitting outside of conventional cyclicality still holds. But we would concede that the dynamics of growth and business scaling are adapting to the higher direct costs of expansion (e.g., higher borrowing costs and wage inflation). Technology companies are among the first to adjust to this, mainly because they were also the ones at the forefront of pursuing expansionary- based scale.

We should not confuse this as being the end of a technology cycle, far from it. As the focus shifts from the pursuit of scale towards tools of efficiency, we think companies that offer or exploit deep productivity- enhancing solutions will come to the fore. You might argue that this has long been the case (e.g. the rise of software tools since the 80s) but productivity growth in most major developed market economies has been lacklustre for several decades[1]. With looming huge improvements in intelligent automation as discussed below, the prospects for meaningful productivity gains look much brighter and we see the role of automation shifting from the current model of assisting humans with mundane tasks towards more value-added assistance or task displacement.

You will have likely heard about some of the recent advances in AI, particularly in the field of generative AI and local language models through tools such as ChatGPT. While AI and machine learning have been in their ascendency in recent years, their relevance has primarily centred upon narrow probabilistic prediction - with the accuracy of that prediction being most influenced by the intrinsic data quality and manual labelling of data used to train a specific algorithm.

Generative AI is focused on building novel content like art, an essay, or lines of code. When challenged, a sophisticated generative AI engine will draw upon the vast breadth of data it has been exposed to, generate an approximate answer and then seek to refine this through critical challenge. Such an iterative process distances generative AI from the narrower predictive AI on several fronts. Strikingly, it can make linkages between discrete observations and deal with areas of ambiguity in what it observes. Moreover, by mimicking mechanisms of natural conscious learning and seeking resolution not statistical perfection, generative AI outputs instinctively feel much more human-like, and it has proven itself to be especially adept at mastering language and dialogue.

At its core, generative AI advances are about delivering context-relevant, digestible outputs that seek to answer real-world queries. Its power can be pointed in many directions, whether creating novel digital content at a hitherto unimaginable scale or as a user-friendly distiller of complexity. The former could see it garner a role in the production of software code or in-silico screening of vast libraries of compounds for use in areas such as drug discovery or battery technology. The latter uniquely positions it to offer a scalable user interface that could ultimately perform various functions such as knowledge search or fully automated customer service. This is fundamentally different from most current technology interfaces which are about delivering blunt and narrow approximations.

What are the implications of all this? Our initial sense is that these impressive but still nascent advances will lay new foundations for how individuals and businesses engage with technology. Much like the arrival of the internet 30 years ago, we see generative AI as a horizontal technology tool that optically lowers the entry barriers within a range of verticals/industries. Traditionally, such a dynamic would be expected to favour nimble disruptors and disadvantage stale incumbents. Yet to borrow further from the experience of internet-based digitisation, while barriers to entry were initially lowered, we suspect that barriers to scale are likely to prove to be much harder to break down and will likely be better determinants when filtering winners from losers within this technology evolution.

While a clear advantage of generative AI is the ability to train it on vast broad data sources, real-world commercial use cases of this technology will likely have a requirement for domain-relevant digital data with which to hone the algorithms. This proprietary data likely exists within businesses that currently cater to their respective end markets. Furthermore, many incumbents (or at least those that remain/have emerged over the past few decades) are digital native businesses - they are unlikely to be refuseniks when experimenting with what AI offers. Taken together our initial view is that for digitally savvy, forward-thinking businesses we suspect that generative AI is more opportunity than a threat. For such companies, this opportunity should be about making deeper engagements with their customers and better leveraging the assets they already have with the prize being to better their offering, take share, and drive deep productivity savings. Given the importance of this topic, we expect it to be a recurring theme in our dialogue with holdings over the coming year.

Managers, abrdn Diversified Income and Growth – 5 June 2023

Global divergence is a key theme for the second half of the year. We continue to think a US recession is, in some sense, "necessary" to restore price stability and bring inflation in line with target. Well-documented banking stresses, as well as the broader evolution of the US data flow, increase our conviction that the Fed's rate hiking cycle is providing the conditions for such a recession. While we have seen some headline making and non-trivial events, banking issues are not, at this time, believed to be a 2008 repeat.

In Europe, while economic data of late has been stronger, underlying inflation pressures remain worryingly strong, which will keep the ECB hawkish in the near term meaning European growth will move broadly sideways. In contrast, we expect China to be the fastest growing major economy in 2023. A strong re-opening rebound is underway, boosting domestic consumption with some knock-on benefits for Emerging Markets in the region and commodities.

With core inflation still ahead of target, central banks will raise interest rates further in the near term. However, the point of peak rates is close, and once the recession commences and core inflation has fallen, a pronounced cutting cycle will begin. The likelihood of recession and the impact on earnings means we are less favourable on corporate risk than earlier in the cycle. We have a preference for investment grade corporate bonds rather than high yield debt as a result.

In the higher yield space, we are maintaining our Emerging Market debt positions. Emerging Market central banks are ahead of developed peers in combatting inflation and will have more room to cut when a global recession hits. We remain mindful of shorter-term volatility in this space however.

We are currently negative on Global Property. Despite the linkage of rents to inflation, we expect the depressed economic environment to erode capital values. In addition, sectors such as offices, are facing severe headwinds from a reduction in demand due to hybrid working, and expensive refinancing rates, with recent headlines of landlords turning the keys over to their banks rather than refinance certain assets.

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UK

(compare UK funds **here, here, here** and **here**)

Robert Talbut, portfolio manager, Schroder UK Mid Cap - 27 June 2023

Since the ill-fated mini budget in September 2022, we have experienced a period of relative calm, in addition to a welcome period of improved performance. However, there remains plenty to ponder, as ten-year UK interest rates have resumed their gentle curve upwards. We first wrote about "eye catching levels of inflation" in the 2021 Annual Report, and the fact is that although the UK economy has been more resilient than the vast majority of market commentators and forecasters expected, inflation remains stubbornly high. In the six-month period reviewed here, the 12-

month rate of Consumer Price Inflation ("CPI") remained above 10%, a level unseen since the early 1980s.

Against this inflationary backdrop, a majority of the companies in the portfolio have fared remarkably well, demonstrating the pricing power we seek. Economic consensus suggests inflation will continue to fall as the year progresses, given lower energy and petrol prices, and it could even be that the suggestions in the media of price limits on certain commodity foods are enough to rein in this particularly sticky element of the inflation cocktail.

Our response, in this environment, is to stick to our strategy of choosing resilient businesses which can deliver high risk-adjusted returns with rising cash flows and earnings. We have maintained our focus on two categories of investment. First, those unique assets with scarcity value and franchise power that allow management teams to raise prices without noticeably impacting demand. The other category is more cyclical businesses or in industries that are undergoing some sort of change, or that might be at some form of a strategic crossroads. This could be industry consolidation, management change or supply retreating out of the market. As a result of this change, we believe these companies will deliver better returns on capital in the future, rewarding shareholders. Additionally, portfolio companies tend to be net cash, or to have low levels of debt. This is important as refinancing costs have increased sharply, hurting profitability, and increasing risks for equity holders.

Despite the consistently negative view presented in the media, there are a myriad reasons to be optimistic about UK mid caps. Consumer confidence is rebounding, with the highest reading for 15 months recorded in May 2023. In April 2023, 20 million adults saw a 10% increase in their incomes. This included over 12 million pensioners receiving the state pension, nearly 6 million receiving universal credit and over 2 million receiving housing benefit. The labour market is strong, and the housing market appears to have recovered from its near-death experience in September 2022.

Furthermore, the lowly valuation of the UK market continues to attract attention from Private Equity and trade buyers. Recent bids for UK mid caps Wood Group, Dechra Pharmaceuticals and Network International attest to this, and, if these valuation levels persist, the trend seems likely to accelerate.

We would also like to remind readers that we are fishing in an attractive pond. In terms of the long-term potential of UK equities, we suggest that investors willing to look beyond the ongoing negative headlines will find the UK punches above its weight. This can be seen in terms of multi-baggers relative to the US, and this is why the Benchmark has beaten the S&P 500 return over the 25 years to 31 March 2023, when measured in local currency. In US dollar terms, it has very nearly matched the popular US index. This is despite the UK mid cap index suffering a substantial derating in the past 24 months. The Mid 250 is populated by multiple "unique" companies, with strong growth prospects, generating cash and delivering attractive returns on capital.

George Ensor, portfolio manager, River & Mercantile UK Micro Cap - 16 June 2023

Despite the recent bounce in equities, investor sentiment remains poor. The hit to consumer income from higher inflation now being realised is evident in consumer confidence which is close to the low of March 2020. The exceptional fiscal and monetary response of the last two years is being unwound through higher rates, excess liquidity withdrawal and higher taxes - measures that are likely to weigh on growth. We should therefore be prepared for ongoing volatility in equity returns, style leadership and investor sentiment.

However, given the underperformance of smaller companies over the last six months, we caution against becoming too bearish ‘after the event’ and note that current levels of consumer confidence have historically been coincident with troughs in its relative performance.

In the short term, we believe we are likely to avoid a recession owing to the strong consumer balance sheet coupled with the positive seasonal effect (i.e. lower prices) in the energy market. We are presumably somewhere near peak disruption to supply chains which means that businesses with reasonable pricing power should sooner or later be able to recover the hit to profitability that supply chain challenges have caused, and robust consumer businesses represent bargain basement – we are selectively finding cases of March 2020 valuation levels on through-cycle metrics, even if aggregate markets are perhaps surprisingly within 10% of all-time highs.

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Wendy Colquhoun, chairman, Henderson Opportunities Trust - 21 June 2023

The valuation of UK equities is at a very low level. A coming together of different factors has been behind the fall in valuations. There has been a lack of capital spend in the economy driven by caution over Brexit and Covid-19. The pension fund industry and various other domestic investors have abstained from buying and have been large disinvestors in UK equities over the last ten years. Overseas buyers have been increasing holdings as domestic holders sell, but their focus is on large global companies, leaving a lack of capital to invest in small, domestic-facing businesses. However, the low valuations are leading to takeover activity picking up.

The UK economy is growing but at a very slow pace. The consumer, in spite of the cost of living crisis, has not shown the weakness in spending that some anticipated. Unemployment is low and companies overall are responding well to the demanding circumstances they face. At the same time, many good quality companies that have sound long term plans are trading on very undemanding valuations.

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Managers, BlackRock Income and Growth - 21 June 2023

Inflation has consistently surprised in its depth and breadth, driven by resilient demand, supply chain constraints, and most importantly by rising wages in more recent data. Central banks across the developed world continue to unwind ten years of excess liquidity by tightening monetary policy, desperate to prevent the entrenchment of higher inflation expectations. Meanwhile, March saw the first signs of financial stress with the bankruptcy of Silicon Valley Bank and Signature Bank in the US serving to highlight the potential issues of the aggressive retrenchment of liquidity. Whilst the ramifications of this crisis remain unclear, it is likely that credit conditions and the availability of credit will continue to recede. This strengthens our belief that companies with robust balance sheets capable of funding their own growth will outperform. We are mindful of this and feel it is incredibly important to focus on companies with strong, competitive positions, at attractive valuations that can deliver in this environment.

The political and economic impact of the war in Ukraine has been significant in uniting Europe and its allies, whilst exacerbating the demand/supply imbalance in the oil and soft commodity markets. We are conscious of the impact this has on the cost of energy, and we continue to expect divergent regional monetary approaches with the US being somewhat more insulated from the impact of the conflict, than for example, Europe. We also see the potential for longer-term inflationary pressures from decarbonisation and deglobalisation, the latter as geopolitical tensions rise more broadly across the world.

We would expect broader demand weakness although the ‘scars’ of supply chain disruption are likely to support parts of industrial capital expenditure demand as companies seek to enhance the resilience of their supply chains. A notable feature of our conversations with a wide range of corporates has been the ease with which they have been able to pass on cost increases and protect or even expand margins during 2022 as evidenced by US corporate margins reaching 70-year highs. As we look ahead into the second half of 2023, we believe demand will weaken as the transitory inflationary pressures start to fade. This will mean that pricing conversations will become more challenging despite continued pressure from wage inflation which may prove more persistent. While this does not bode well for margins in aggregate, we believe we will continue to see greater differentiation as corporates’ pricing power will come under intense scrutiny.

The UK’s fiscal policy has somewhat diverged from the G7 as the present government attempts to create stability after the severe reaction from the “mini-budget”. The early signs of stability are welcome as financial market liquidity has increased and the outlook, whilst challenging, has improved. Although the UK stock market retains a majority of internationally weighted revenues, the domestic facing companies have continued to be impacted by this backdrop, notably financials, housebuilders and property companies. The valuation of the UK market remains highly supportive as Sterling weakness supports earnings of international companies, whilst UK companies are in many cases at COVID-19 or Brexit lows in share price or valuation terms. Although we anticipate further volatility ahead as earnings estimates moderate, we know that in the course of time, risk appetites will return, and opportunities emerge.

Charles Montanaro, manager, Montanaro UK Smaller Companies Investment Trust - 19 June 2023

The IMF is forecasting that interest rates will return to "rock bottom" due to chronic low growth in the developed world, linked to low productivity and ageing populations. Such forecasts are interesting insofar as they highlight just how unusual 2022 was. Interest rates soared as a result of the economic dislocation of COVID and the war in Ukraine, rather than underlying structural trends.

Unusually, the Quality and Growth styles significantly lagged the market last year. As Quality Growth, SmallCap investors, it will always be challenging when Quality, Growth and SmallCap all underperform - especially at such extreme levels. UK SmallCap posted its worst performance relative to Large Cap (21%) in 2022. However, it is unwise to become too down-hearted by one year. We have long argued that UK SmallCap is an attractive asset for long-term investors. It is important to give companies time to grow over time and different cycles. Taking a longer perspective, since January 1955, UK SmallCap has outperformed in 78% of the 70 ten-year rolling periods since then and in 99% of the 30-year rolling periods (see chart below):

As time ticks by, the impact of the black swan events described above appears to be fading. Global inflation has largely stabilised and investors are now pricing in the first interest rate cut as early as September 2023 in the US and March 2024 in the UK. The headwinds of the past 18 months might soon turn into tailwinds. However, we claim no expertise in forecasting macro-economic developments and waste little time in trying to do so. Instead, we talk to our companies. We continue to be reassured by their performance.

Although SmallCap remains out of favour as we write these lines, we cannot help but feel increasingly positive about what it holds in store for the coming years. At 31 March 2023, the Numis Smaller Companies (ex-IC) index was trading on 9.8x 12 months-forward earnings, 22% below its long-term average. To put things into perspective, since 2006 the index has only traded on a P/E of below 10x in 23 of the 198 months, i.e. 11% of the time. Every single time this has happened, it was followed by a year where SmallCap outperformed significantly (averaging a remarkable 23%).

More importantly, as someone brought up to recognise that you cannot eat relative performance, when UK SmallCap has fallen then the following three years have seen strong absolute returns. Last year saw the sixth worst year of absolute returns as the chart below shows (we will have to wait to add the figures for the next three years).

It is hard to recall such indifference to the asset class. As someone with more grey hair than most who has lived through seven Bear markets, it is hard not to be excited about investment opportunities especially for long-term investors. To borrow the words of Andrew Jones, the highly regarded Chief Executive of LondonMetric Property PLC: "*when you invest in quality, time will help you to create wealth".*

Since UK SmallCap appears to be cheap, you would expect take-over activity to pick up. Already there are signs that M&A activity is indeed rearing its head again.

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Andrew Watkins, chairman, CT UK High Income Trust - 1 June 2023

After two years of COVID and dealing with its aftermath, the world was plunged into further uncertainty by Russia. The effects on shareholder returns have been magnified in both directions over that three-year period, first fuelled by a total change in working practices amid massive (and expensive) Government support packages and then through rising energy prices and supply chain shortages leading to yet more (expensive) support, especially for the vulnerable and elderly. Added to this, in the UK came the advent of three Prime Ministers in a matter of weeks; the haphazard policy announcements that ensued caused serious disquiet in the gilt market which has only recently subsided.

A long period of near-zero interest rates probably led many to believe that borrowing money at such levels was the norm and unlikely to change anytime soon. The slowly dawning realisation that interest rates had to rise to defeat inflation has had the anticipated effect on the country but, miraculously, has not collapsed the economy, regardless of the inevitable squeeze on household budgets, or affected employment numbers as businesses still find it difficult to fill vacancies. Nor has it led to recession or to a stock market rout.

However, uncertainty is always the enemy and whilst the resilience of all the above is commendable, a period of calm in the wider world and stock markets in particular would be welcome and possibly key to making positive headway. Given war is on Europe's doorstep and the rhetoric more alarming by the day, it is all the more remarkable that the UK's FTSE 100 index recently hit an all-time high.

I sound all doom and gloom and I really don't mean to be. It is likely that interest rates and inflation have peaked with the latter forecast to be nearer 5% by the end of 2023. This should help resolve many of the difficulties currently being experienced brought about by the likes of soaring energy prices, now thankfully abating, and wage demands, with more realistic settlements likely to be achieved.

Jonathan Cartwright, representative of the board, CT UK Capital and Income Trust - 1 June 2023

It might be tempting to think that the opportunities for UK equities are lacklustre as the stock market has already shown some signs of recovery since the start of the financial year, yet the economy is apparently struggling to produce any meaningful growth. Furthermore, inflation is proving more persistent than expected and interest rates are probably staying at higher levels for longer, which would normally be considered a headwind for businesses and share prices. We are also very aware of the emerging risk of instability in the US financial sector but, as yet there appears very limited read across to the UK.

All these points of caution, however, ignore the actual experience of many of the companies in our portfolio where sales, profits, earnings and dividends are increasing and where valuations appear undemanding. As has already been stated, share prices can be impacted by macro-economic events but, across a longer-term timeframe, fundamental value should be reflected in improving individual share prices as companies deliver superior performance.

Europe

(compare European funds **here** and **here**)

Francesco Conte, manager, JPMorgan European Discovery Trust – 15 June

We began 2022 believing that inflation would prove to be transient. However, the tragic events in the Ukraine followed by Covid-19 lockdowns in China resulted in the risk of more persistent inflation.

More recently there have been signs that we have passed peak inflation, although inflation could stay elevated above Central Bank targets for some time. Markets feel much more optimistic than at any time since inflation began increasing mid-way through 2021. Sentiment is supported by falling energy prices and China reopening paving the way for a boost to European manufacturing exporters.

Nevertheless, the economic outlook is uncertain. Some leading economic indicators are under pressure and the US yield curve remains inverted which has historically led recessions, albeit with an unpredictable delay. There is a risk that earnings downgrades are coming for more cyclically exposed companies although there are no signs of this yet in order books. As a result, active management and thorough fundamental research will be paramount, and quality - of both management and balance sheets - will be imperative in a more uncertain environment.

2022 was a difficult year in absolute and relative performance. However, 2023 looks much more encouraging. While the last decade has been all about the US and technology, Europe looks extremely attractive in this new cycle as it starts with compelling valuations and, unlike China which also looks cheap, seems to be in a period of relatively harmonious internal politics, although Russia remains a wildcard.

Another uncertainty is how Artificial Intelligence ("AI") will impact companies and sectors in the future. Just like the internet, AI will have a profound impact. But, like the internet it is difficult to predict the exact consequences. Nevertheless, it is likely that AI will have an overall positive impact on economies and equity markets due to efficiency gains. Companies will need to adapt; those that do not, risk being fatally disrupted. However, companies that take advantage of AI will reap the rewards. Understanding these consequences will be an important focus for the Investment Managers.

In relative terms, 2022 was very macro driven - such periods do not last forever and eventually bottom-up fundamentals reassert themselves. We expect this to be the case in 2023.

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Mangers, JPMorgan European Growth & Income – 6 June 2023

The market is facing ongoing uncertainty about the inflation outlook and whether Central Banks can engineer a soft landing in which inflation is reduced without tipping economies into recession. While we continue to believe that the European banking sector is much more robust than it was during previous financial crises, we remain alert to the speed with which things can change and will act accordingly if required. On a more positive note, the concerns mentioned above are well known to the market and may already be priced in. On a longer term view the Company's Managers continue to believe that the investment universe of European companies contains many high quality enterprises across different sectors and often with global reach. Moreover, the valuation of European markets continues to look attractive, particularly in comparison with the US, but importantly within the market too. Valuation spreads remain wide which suggests that there will be opportunities for stock selection to continue to add value.

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Japan

(compare Japanese funds **here**)

Managers, JPMorgan Japan Small Cap Growth and Income – 23 June 2023

The external environment is uncertain, pervaded by geopolitical tensions, the risk of a global recession, and persistent concerns about inflation and interest rate hikes. Japan is also seeing signs of inflation, as rising commodity prices and a weaker yen have imported inflationary pressures although inflation levels are lower than in other major markets. However, as one response to Japan's tight labour market conditions, some large corporates have started to announce generous wage increases, to attract and retain workers. These increases follow decades of stagnant wages, so this is very encouraging for the Japanese economy. On the monetary policy front, following the BoJ's monetary policy tweak in December 2022, financial markets are awaiting further policy guidance from the BoJ's new governor.

Regardless of these external and domestic events, we remain optimistic about the long-term outlook for Japanese small cap companies, and your Company, for several reasons. The average valuations of Japanese companies remain reasonable, and lower than both historical averages and valuations in most other major markets. Furthermore, Japanese equity markets will draw near-term support from Japan's belated lifting of COVID-19 restrictions. Japan reopened its borders in October 2022, much later than most other developed nations, and just before China's surprise decision to abandon its zero COVID-19 policies. So inbound tourism and a general reopening of the Japanese economy have only just gained traction in recent months. China's reopening is also supportive for many Japanese companies.

However, in our view, the most important structural support for Japan's equity market over the medium to longer term will be the ongoing improvement in corporate governance. The past few years have seen clear progress on this front, in large part thanks to the Corporate Governance Code introduced in 2015. We have seen notable improvement in areas such as board independence, and we expect more positive developments ahead, especially increased shareholder returns. Half of Japan's listed non-financial companies still have net cash positions, so there is significant scope for this cash to be returned to shareholders over the longer term.

The pandemic has given added impetus to some other positive structural changes underway in Japan, especially the application of technology and digitalisation in many areas of economic activity. These trends will underpin growth, productivity and corporate earnings for years to come. In sharp contrast to other developed economies, Japan's smaller companies are at the forefront of this innovation and change making them ideally positioned to prosper over the long term. However, the sell side coverage for such exciting mid- and small-cap companies tends to be thin, so many investors overlook the compelling opportunities available in this sector of the market.

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Harry Wells, chairman, CC Japan Income & Growth Trust – 20 June 2023

While inflation is not so rampant in Japan compared to many other countries, it continues to broaden and climb with core inflation running at over 3.4%. This should encourage domestic flows back to the stock market which offers higher yields compared to the zero return on bank deposits. Surprisingly, local investors are still selling into strength with the TOPIX hitting a 33 year high up 10.1% in sterling terms in the calendar year to the end of April 2023. However, foreign investors are returning, attracted by economic trends, policy developments, attractive stock valuations and not least extensive media and press coverage hailing that the long bear market in Japan is finally over. Certainly, Warren Buffet has recently highlighted the growing attractions of Japan and has increased the stakes in the five trading companies that Berkshire Hathaway first acquired in 2020. The trend of returning cash to shareholders through share buy backs and dividends has been further stimulated by recent announcements by the Tokyo Stock Exchange ("TSE") and Japan's Financial Services Agency ("FSA"). Their measures are designed to accelerate the restructuring of the many companies that trade below book value, while encouraging greater balance sheet efficiencies and radical overhaul of capital allocation. This is all evidence of a continuing and refreshing commitment to corporate governance reform.

The economy is increasingly gaining traction post the pandemic and with China's reopening in January 2023. We are seeing increased confidence in corporate earnings and consistent improvement in the level of dividend distributions across our holdings in the portfolio. Against this, the growing disparity of interest rates between sterling and the yen continues to put pressure on the currency cross rate, reducing Japanese income on translation to sterling if the yen continues to weaken.

Continued geopolitical tension especially between China and the USA in addition to the unpredictability of the North Korean regime, also remains a risk. Providing that these tensions do not worsen, the outlook for Japan is increasingly rosy, particularly for investors who recognise that income is a critical component of total return.

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Kwok Chern-Yeh, managers, abrdn Japan Investment Trust – 5 June 2023

One of the most significant developments domestically over the year to 31 March 2023 was regarding the Bank of Japan (BoJ) and monetary policy. Despite inflation creeping up to its highest level in more than 30 years (albeit much lower than elsewhere), BoJ Governor Haruhiko Kuroda stuck to his no-intervention policy for much of the year, even in the face of an increasingly weak currency; the yen fell to its lowest point against the US dollar in more than 20 years. At the same time, the

BoJ remained committed to its policy of yield-curve control and restricting sales of 10-year Japanese Government Bonds to ensure that yields stayed around zero.

Towards the end of 2022, the BoJ relaxed its rules. And, with Kuroda's retirement in April 2023, there are expectations that new governor Kazuo Ueda will start to unpick some of the policies that have been pushed through in previous years. If this happens, the banking sector could start to become more profitable. Notably, despite some profit-taking and news from the US regarding the failure and subsequent buyout of Silicon Valley Bank, financials were the best performing sector over the review period.

Prevailing global concerns - the ongoing Ukraine war, rising inflation and disruption to supply chains - combined with domestic worries, not least the weaker yen, weighed on the market. While companies considered to be more sensitive to rising interest rates, and the more 'defensive' sectors fared well, most other sectors lost ground. The weaker yen was particularly damaging for the margins of the better quality companies favoured by the Investment Manager.

There are already signs of improving macroeconomic conditions. The yen has bounced back from its October lows, there is general consensus that interest rate rises that have hurt the global economy should slow from here, while soaring inflation should slowly start to moderate. Meanwhile, China's reopening is proving to be a positive for the supply-chain issues that have beset many Japanese businesses, where shortages of essential components, such as semiconductors, have delayed production.

Looking ahead, there is cause for optimism. The macroeconomic conditions that have hurt some of our holdings in the recent past appear to be reversing: the yen has strengthened, inflationary pressures are easing, and interest rate rises are moderating. While there are still concerns that the market may be underestimating the persistence of inflation, and that geopolitics could still lead to sudden changes in the economic outlook, we believe that the prospects for better run businesses in Japan should improve and, over time, see them outperform.

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Nicholas Weindling, investment manager, JPMorgan Japanese Investment Trust – 2 June 2023

We are heartened by some recent improvements in Japan's near-term economic prospects, and on balance we expect activity to continue to expand, supported by the re-opening of both the Japanese and Chinese economies. We are also encouraged by early signs of upward pressures on wages and by rising inflation, as this provides hope that Japan may be pulling out of its long period of damaging and seemingly intractable deflation. This would be a welcome development from the BoJ's perspective, so, unlike the case in other major economies, we do not expect the central bank to try to quash nascent inflation pressures by implementing aggressive rate hikes.

The outlook for Japanese corporates is also positive. Company balance sheets are very strong compared to the rest of the world, and the focus on corporate governance and shareholder returns is increasing. For example, in February 2023 the Tokyo Stock Exchange announced that it will require companies trading below book value to devise and implement capital improvement plans. We expect progress in corporate governance and shareholder returns to continue apace, and in our view, this remains the single most compelling reason to invest in Japanese equities on a multi-year view. Half of Japan's listed companies still have net cash positions, so there is significant scope for this cash to be returned to shareholders over the longer term, while in the short term, cash-rich businesses have greater scope to weather global recession and other unforeseen events.

Another key factor supporting our favourable view on Japanese equities is that the country is undergoing major technological transformation. Businesses and government are increasing their efforts to digitalise and automate their processes and administrative procedures, creating the potential for significant growth and productivity gains over the medium term. This should prove a very supportive environment for the dynamic, quality growth businesses in which we invest.

The Japanese market continues to offer many opportunities to invest in innovative, interesting companies at the heart of Japan's new growth, at attractive valuations.

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North America

(compare North American funds **here** and **here**)

Managers, BlackRock Sustainable American Income Trust – 28 June 2023

The start of 2023 finally showed the effects of the fastest Fed tightening cycle since 1980. The bank closures of Silicon Valley Bank, Signature Bank and First Republic Bank illustrated the increased challenges of operating in a high inflation, high interest rate economy and the fallout in our view is unlikely to change that. With regional banks remaining under pressure, we see consumer lending continuing to slow, which may further tighten financial conditions. Investors should remain mindful that we are only just over a year removed from the first Fed rate hike, meaning financial conditions were already set to tighten before March's banking events. From a market perspective, this may create additional volatility if we see more negative outcomes related to a sluggish US economy. Despite a more challenging macro environment, we do not see the Fed cutting rates this year as core inflation proves to be resilient. We feel the Fed should prioritise curbing inflation as a premature interest rate cut could create additional economic challenges. Looking ahead, we continue to focus on resiliency by investing in high-quality businesses with strong fundamentals as we look for the economy to stabilise. While we see short-term choppiness ahead, we remain constructive of US equities in the long term.

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Emerging Markets

(compare emerging market funds **here**)

Managers, JPMorgan Emerging EMEA Securities – 19 June 2023

Firstly, in 2022, GCC countries received US$1 trillion in revenues from energy exports. This represents a massive injection of capital into the region, which will manifest itself via higher consumption spending and infrastructure investments. In addition, as we discussed above, we expect oil and gas prices to rise in the second half of 2023, which will provide further support for energy companies, while earnings per share more broadly are likely to be 10-20% higher than initial estimates for 2022. Furthermore, just like their UK, European and Asian counterparts, some emerging market banks are benefiting from the rise in global interest rates. This should provide a significant additional boost to the market, as banks comprise almost 40% of the index. The portfolio's exposure to financials will benefit accordingly.

In terms of overall GDP growth, activity in 2023 will not be as robust as in 2022, but it will still be strong, with regional growth running at a respectable pace just shy of 4%. The UAE, Qatar, Saudi Arabia and Greece will be positive outliers. The laggards will include Turkey and South Africa. In addition, inflation will be lower across the region thanks to interest rate tightening already in place.

Emerging markets in the Middle East and Africa are growing and evolving very rapidly and the opportunities created by this evolution will escalate over time. For example, last calendar year, 20 new companies entered the Company's investment universe via initial public offerings (IPOs).

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Chetan Sehgal, lead portfolio manager, Templeton Emerging Markets – 12 June 2023

Heading into 2023, while we remain watchful for developments that could change our overall outlook, including China's relationship with Taiwan and the United States, we find many reasons to be positive about EMs. Many countries are towards the end of the rate tightening cycle. Most markets in Latin America have traditionally had a significant real interest rate and their economic potential has been curtailed because of the need for macroeconomic stability.

We expect any policy pivot in EMs to revive consumption and spur economic growth as inflation slows. In addition, after a slowdown in earnings in 2022, there is the prospect of a recovery in earnings growth in 2023, with China being the last major country to emerge from the pandemic. However, in the short-term, earnings are likely to remain weak with subdued consumption and inventory digestion and a recovery is expected more towards the second half of 2023. A pickup in earnings revisions in EMs would signify better times ahead for equity markets.

Although the current global outlook remains weak, economies with a greater focus on domestic demand are better placed to weather this in the near term. Many emerging markets such as China, India, Indonesia and Brazil have huge domestic consumption bases and are well-positioned to remain resilient from external demand shortfalls. In addition, policy makers in several markets are providing incentives to manufacturing companies to expand operations in order to remain selfsufficient and competitive. For example, India is driving investments through its Production Linked Incentive program. South Korea plans to offer tax breaks to semiconductor and other technology companies investing within the country whilst reforming stock market regulations. Thailand has also approved a budget to boost tourism in the country, one of its biggest growth drivers.

The long-term structural tailwind of consumption growth in EMs via expansion of the middle class and premiumisation of buying patterns is now more significant than ever. Some US$2.6 trillion in Chinese bank deposits were amassed in 2022(a) and middle-class households are looking to spend on experiences, products and services. In our view, China's reopening could benefit many markets as the country has strong trade links with many EMs. Chinese tourism has also been a vital source of revenue for many countries.

After the removal of most COVID-related constraints, we have seen economic activity in China starting to recover in the first quarter of 2023, where retail sales, industrial production and investment in fixed assets increased. More importantly, companies are now able to operate their businesses without COVID protocols which removes the pressure of unplanned outages and improves overall efficiency.

Markets in Eastern Europe will benefit from the normalisation of energy dislocations, although the conflict in Ukraine will continue to be an overhang. Markets in the Middle East continue to see a boom in initial public offering activity which bodes well for future capital market developments in the region.

These uncorrelated drivers of returns in EM economies present an investment opportunity which our team's deep experience, local expertise and a bottom-up investment approach can uncover.

EMs also continue to make strides towards climate goals and with the cost of renewable energy expected to fall in 2023, we might well see EMs make further climate commitments.

It is an interesting time to be looking at the emerging world today. We believe that the breadth of opportunity, growth, innovation, sustainability of business models and the much stronger institutional resilience compared to decades past when considered together create an attractive future for EMs.

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Managers, Barings Emerging EMEA Opportunities – 9 June 2023

In the short term equity markets are likely to remain volatile as investors monitor developments in Ukraine, as well as the outlook for inflation and global economic growth. However, there is evidence that monetary tightening may have moderated inflation which is supportive. While the region will not be immune to these global trends, we believe there are a number of compelling opportunities across EMEA.

The Middle East continues to invest large sums of capital to further diversify their economies. This, combined with robust consumer demand, lower inflation and higher labour participation rate should continue to support earnings growth across multiple sectors. The representation of the Middle East in major indices has risen recently, whilst a burgeoning IPO market is broadening the investment opportunity. Interestingly, Middle Eastern markets remain underrepresented within investor portfolios, which – in combination with the region's economic and structural tailwinds mentioned above – should help increase demand across the region's equity markets.

South Africa presents another interesting investment opportunity, primarily because of its access to a broad range of metals, many of which have a role to play in the energy transition. High commodity prices have helped improve the country's fiscal position, whilst increased demand from China reopening its economy will also be supportive. Political risk has increased recently and we remain vigilant to the potential for social unrest, whilst the country struggles to resolve the problem of electricity supply outages.

Markets across Central and Eastern Europe look set to have a softer economic landing than originally feared, helped by the significant fall in energy prices. Opportunities will exist as the region pivots away from Russian gas, particularly via the support of large EU infrastructure projects, such as the European Green Deal and NextGen EU funds. The region is also well placed to take advantage of nearshoring trends via the provision of lower cost skilled labour, strong regulatory protection, and crucially, a lower delivery time for the end consumer.

While Emerging European, Middle East and African markets have experienced challenges, the recent market volatility has also resulted in a potential opportunity, particularly for long term investments in high quality businesses with the potential for earnings growth that have seen their share prices weighed down by broader market moves. Markets continue to digest near term challenges to economic growth, alongside shifts from disruptive technological innovation and geopolitical tensions, all of which may cause mispricings from which the portfolio can benefit. This, however, creates an environment in which divergence in company performance is likely to increase as companies adjust and winners emerge stronger This environment offers improving opportunities for active management to secure outperformance.

Managers, BlackRock Frontiers Investment Trust – 5 June 2023

We still believe global markets are in the process of adjusting to a world of higher inflation and higher interest rates. The banking sector fragility we saw over the course of March is one indicator that this level of interest rates is starting to bite. Equally, we believe we are near a peak in the US Dollar and that provides a favourable setup for frontier markets that posit supportive economic fundamentals and policy making.

We retain an overweight exposure in Indonesia and Chile as both fit our macro-economic framework. In particular, the Indonesian economy is positioned to sustain high single digits nominal GDP growth given policy-making remains favourable to attract foreign direct investment and continue to grow its exports base. We have an optimistic view on Indonesia's ability to grow its value-added nickel exports that the global EV battery supply chain will increasingly rely on. Indonesia holds one of the largest nickel reserves in the world and is quickly developing these into higher density battery grade nickel for NCM batteries. This will support Indonesian balance of payments and allow for more sustainable economic growth given Indonesia remains under invested in most sectors by relative emerging market standards. Our favourable view on Chile is predicated on the country implementing an orthodox monetary and fiscal policy which has enabled inflation to roll over and we believe there is value in stocks there as the interest rate cycle normalises.

GEOPOLITICAL FACTORS

From a geopolitical standpoint, the world looks increasingly split into three blocks: the 'Western' block such as Europe, US, South Korea, Japan, Australasia, the 'Eastern' block such as China, Russia, North Korea, and some Chinese aligned African nations, and then the 'Neutrals' such as India, Brazil, Saudi Arabia and much of the rest of South America and the Middle East. Most of the countries within our Frontier Markets universe are considered 'neutrals', and should benefit as the global geopolitical alliances recalibrate.

It is clear to us that these geopolitical concerns have already prompted a supply chain recalibration away from China and countries such as Vietnam and Malaysia will continue to see the benefit of re-shoring of supply chains.

Finally, we observe a marked contrast in the monetary and fiscal policy decisions taken in the small emerging and frontier markets versus developed markets in the post-pandemic years, and we find significant value in currencies and equity markets across our investment opportunity set. We are optimistic over the long-term in our under-frontiers investment universe which should enable compelling investment opportunities.

China

Helen Green, chairman, abrdn China Investment Company – 28 June 2023

The Chinese economy appears to be moving in the right direction. After a lengthy period of social and travel restrictions, we believe there is pent-up consumer demand in China. The reopening that is already underway should lead to a multi-stage recovery, with a gradual revival of domestic consumption. In turn, this should boost sectors ranging from tourism to healthcare, and property to banks.

China's economic recovery appears to be underway, albeit at a slower and more gradual pace than elsewhere in Asia. This recovery is aided by supportive financial conditions. China's inflation is lower than surrounding countries, meaning authorities have been more able to introduce accommodative monetary and fiscal policies to support economic growth. Projections from the International Monetary Fund ("IMF") earlier this year forecast that China's economy will grow 5.2% in 2023 (compared with 3% in 2022). China's economy is also expected to contribute one third of overall global growth. Although the IMF also points out that "comprehensive macroeconomic policies and structural reforms" are still required.

At the heart of China's economic growth is its rising middle class, providing opportunities to invest in companies that are set to deliver long-term capital growth. These companies are benefiting from rising affluence leading to growth in consumption, growing digital integration and more widespread technology adoption, the move to a greener, lower-carbon world, greater demand for healthcare products, and structural growth in consumer finance.

Mike Balfour, chairman, Fidelity China Special Situations – 7 June 2023

While the mood of investors in Chinese equities has swung between extreme bearishness and euphoria over the past year, the current backdrop reflects a more measured outlook. The Board continues to believe that a direct exposure to China – the world's second-largest economy – is an important constituent of a diversified portfolio. Although economic growth was lacklustre in 2022, the International Monetary Fund expects China's GDP to advance by 5.3% in 2023, ahead of the 3.9% average for emerging markets and developing economies and well in excess of the 1.3% forecast for advanced economies.

China is at a different point in the economic cycle to the rest of the world; rising interest rates and inflation in the West have meant very constraining central bank policies aimed at slowing economies down, whereas the opposite is the case in China. Inflation is not and has not been a problem and the authorities are taking a more stimulative approach to boost growth. This is being done at a measured pace to reduce unemployment, particularly amongst the young, but at a level which doesn't fan speculation in the property sector which remains an issue.

ESG standards continue to improve, and as Western governments experiment with increasingly protectionist policies and try to tame inflation, opportunities increase for China to move up the value chain in manufacturing and services.

Against this improving backdrop, valuations in the stock market, and in particular those of small and mid-cap companies in China, remain relatively modest, with arguably the best opportunities to be found among the less well-known companies that may be overlooked by funds that lack a solid on-the-ground research presence.

While the Chinese stockmarkets are always likely to be volatile, we are encouraged that all the building blocks remain in place for continued healthy returns. There will be slips along the way and we remain mindful of geopolitical issues such as the relationship with the US and the status of Taiwan, however structural trends such as the growing middle class and on-going innovation support our positive medium to long-term view.

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India

Michael Hughes, chairman, abrdn New India Investment Trust – 28 June 2023

India remains one of the world's fastest-growing economies, sustained by a stable macroeconomic environment. Supportive government spending, a revival in consumption and an easing of supply chain bottlenecks are likely to provide a buffer against rising interest rates and a likely global slowdown.

With a pro-growth budget for the 2024 fiscal year, there is increasing focus on India's industrial policy, as the country seeks to entrench its position as a global manufacturing hub. The domestic economy is in the early stages of a cyclical upswing. Inflation is easing, and there is good momentum in real estate, infrastructure development and consumer spending.

That said, we must remain cognisant of the risks. Stockmarkets remain volatile and the external pressures on India have not eased. The next 12 months remains uncertain, with no end in sight to the Russia-Ukraine conflict, an expected rearrangement in global supply chains and a looming recession in the United States. However, India's swelling economy and domestic demand, robust macroeconomic management and proactive policy measures mean that the country is well-placed to tackle such external headwinds.

Managers, JP Morgan Indian Investment Trust – 9 June 2023

In our view the short-term weakness of Indian markets relative to other equity markets is just that - short term. Markets, like stocks, rarely move in one direction. There are some natural bumps along the way, but we believe the long-term outlook continues to remain attractive. As an economy, India continues to tick the key top-down factors most investors care about - namely a strong democracy; fair and independent institutions; strong banking system; low leverage and economic growth expectations materially above any other global economy.

For these reasons, we believe India is on the cusp of being able to deliver a high rate of economic growth over multiple decades driven by strong local demand, an increase in in investment not only domestically but also from overseas as it is becoming a globally attractive investment destination. The advantage of land and labour is on the cusp of meeting demand both domestically and globally.

As most developed and emerging countries globally continue to struggle to expand their economies, our expectations are for India to remain one of the fastest growing. We estimate real GDP growth at around 7% for 2023 coming down to around 6% in 2025 but, encouragingly, being able to sustain this level of growth for many years beyond this. It's difficult to find any other economy around the world that comes close to that. India has already overtaken the UK to become the fifth largest economy and based on estimates will likely become the third largest economy in the next decade.

Demographic Dividend

Many readers will be aware that India's population has recently overtaken China's to become the most populous country in the world. The fact that the age distribution in India is more weighted to economically active age groups underpins the structural opportunities in many sectors of the Indian economy. This, combined with the increase in income for lower-earning households, will, in our opinion, continue to drive higher demand from consumers. The combination of rapid urbanisation, a growing population, rising household affluence and improving accessibility of goods and services will drive the twin engines of consumer demand in India - staple goods and discretionary products - where we can find attractive investment opportunities.

Capital Expenditure meets demand

Post the global financial crisis, it's fair to say that India missed a significant capex cycle. We have previously described this as the lost decade. However, that is only one part of the story. Over that period the government has made significant strides in terms of getting the foundation laid to allow for a new cycle which can be a much longer and more sustainable period of investment-led growth. This all comes at the same time as growing demand from international companies looking to have a balanced and diversified manufacturing base to ensure long term security. India offers an abundance of natural resources and a growing labour pool, which is highly skilled and low-cost. Many readers will have already read about Apple's plans to switch manufacturing of iPhones to India. This, in our view, is just the beginning. In addition, we are starting to see a material pick-up in investment in areas like railways and road transportation, as well as in the manufacturing side. The combination of all these factors, gives us confidence about the outlook for growth. The banking system, that will be so important to be able to support this growth, remains in a sound position to be able to provide lines of credit as required.

IT Services

While this area, undoubtedly, is more connected to global growth expectations than other areas of the Indian economy, we still believe the long-term opportunity here remains extremely attractive. The talent pool mentioned above means that there is really no alternative for global corporates thinking about digital or cloud. Moreover the low cost of this talent pool means the opportunity here remains robust though with some level of cyclicality. We are less concerned with the noise around the short term. If anything, this is where investors like us, that can take longer-term views, will see the biggest opportunities present themselves.

Valuations

We are often asked about market valuations and whether we think the India equity market is expensive. Part of the answer to this question lies with investors' time horizon. But also, more fundamentally according to a theoretical framework which we use to analyse and value individual stocks, the key components that drive the value of any business are its growth rate and the return on equity (ROE). Using the same lens for the market, we have long argued about the much longer and higher duration for the India equity universe. However, on top of that the Indian equity market has consistently delivered the attractive combination of a much higher average ROE and a lower variation around that coupled with the higher long-term growth. This provides ample justification for higher long-term multiples. We don't view market valuations to be out of sync with the long-term opportunity.

In addition to the above, the long-term opportunity for any market is a function of two main drivers: 1) Dispersion - the difference between the best and worst performing stocks i.e., the ability to add value in stock selection and 2) Opportunity set. The India equity universe combines a high dispersion within the opportunity set with a large universe in which to invest. Hence the best backdrop for return generation.

So, all in all, there are many reasons to be optimistic about the long-term prospects of the Indian equity markets. Volatility such as the market experienced over the past six months is to be expected at times, although it is never comfortable. But we view investing as a marathon, not a sprint, and we remain confident that the Indian market offers just reward for patient investors willing to stay in the race.

Biotech and healthcare

(compare biotech and healthcare funds **here**)

Managers, The Biotech Growth Trust – 15 June 2023

Macroeconomic factors rather than industry fundamentals continued to dominate portfolio performance during the fiscal year. The fiscal year began with weakness in the biotech sector in April and May 2022, driven by continued investor concerns about rising interest rates. Continued rate hikes by the U.S. Federal Reserve (the Fed) to combat inflation drove down share prices for unprofitable technology stocks broadly, including emerging biotech. Valuations for emerging biotech, which had reached 20-year lows, appeared to bottom out in May and June. In August, drug pricing legislation in the U.S. was passed as part of the Democrats' "Inflation Reduction Act". While the bill allows for limited drug price negotiation by Medicare starting in 2026, the provisions appear manageable for the industry and passage of the bill cleared a longstanding political overhang for the sector. By the end of September, the biotech sector had begun staging a recovery from depressed levels. In October, a disappointing round of earnings from large capitalization (cap) technology stocks like Amazon and Meta and growing recession concerns appeared to draw generalist inflows into the defensive pharmaceutical sector and large cap biotech. Large cap biotech outperformance continued in November, but small cap biotech began outperforming in December, and January 2023. Unfortunately, interest rate expectations became more hawkish in February when the U.S. announced a lower-than-expected unemployment rate and higher-than-expected inflation, sending small cap shares back down. In March, the unexpected failure of Silicon Valley Bank (SVB) had a particularly negative impact on small cap biotech, many of which were SVB clients. Even though absolute cash exposure to SVB for most biotech companies was minimal, renewed risk aversion due to the concerns over the banking system caused large cap biotech to significantly outperform small cap biotech.

Our positioning at the beginning of the fiscal year was premised on overweighting smaller cap emerging biotech names for three reasons:

1) Emerging biotech was trading at 20-year valuation lows, with almost 20% of the industry at the start of the fiscal year trading at negative enterprise values (market capitalisation below the net cash on the companies' balance sheets). Small and mid cap biotech companies had significantly underperformed large cap biotech and the S&P 500 since early 2021 and a reversion in performance based on historical patterns seemed likely.

2) We expected an increase in M&A activity due to the compelling valuations of smaller biotech targets.

3) Emerging biotech, rather than large cap biotech, was still contributing about two-thirds of the total biopharmaceutical industry pipeline. Fundamental innovation was strong.

All of these elements of our investment thesis remain intact. Indeed, we think emerging biotech was showing good signs of a recovery from the lows of summer 2022, but the banking crisis in March 2023 temporarily derailed that rerating. We believe biotech companies have largely eliminated their direct exposure to bank failure risk by diversifying their banking relationships, holding cash at banks that are deemed “too big to fail” (e.g. J.P. Morgan, Bank of America), and moving their cash into alternate liquid securities. Most emerging biotech companies rely on equity financings rather than debt financings to fund their operations, so we think they are better insulated than other industries from any pullback in bank lending activity.

We are also encouraged by current market expectations that the Fed’s recent cycle of rate hikes may be coming to an end. Fed comments following their recent May 2023 meeting were widely interpreted as signaling that a pause in interest rate hikes could occur as early as June. As a result, we think the macro factors that have weighed on the sector so heavily over the past two years should soon abate, allowing the sector to recover.

We believe large cap biotech outperformance is principally driven by generalist investors seeking defensive investments during a time of macro volatility. Large cap names are better insulated from interest rate hikes and have lower beta – a measure of their sensitivity to broader market moves – during market downturns. At a time when investors are focused on maintaining liquidity in their portfolios, large cap names offer greater liquidity than their small cap counterparts. Additionally, drug sales are less economically sensitive than other sectors during a recession, making large pharma and large biotech companies with marketed drugs natural places to hide for generalist investors concerned about recession risk. We would caution that investors may be temporarily parking money in large cap biotech primarily as a means of managing macro risk rather than investing based on enthusiasm for those companies’ individual fundamentals. When the macro picture improves, that capital may quickly reallocate to other sectors of the economy. While large cap biotech does have some defensive qualities during a recession, recent analysis from Goldman Sachs shows that small and mid cap biotech (as reflected by the SPDR S&P Biotech ETF or XBI) have also outperformed the S&P 500 during the last four recessions.

We have noted in the past the increasing biotech innovation we are now observing in China. The Chinese central government made developing a domestic, innovative biotech industry a priority in 2015, and we believe the COVID pandemic has only strengthened that commitment. According to IQVIA (a provider of biopharmaceutical development and data analytics services), about 15% of the drug industry’s early-stage development pipeline is now being developed by Chinese companies, a dramatic increase from the 4% level in 2012.

In 2021, significant macro headwinds in China led to a general decline in the Chinese markets, which caused Chinese biotech stocks to decline. Headwinds included regulatory tightening by the Chinese government, slowing economic growth due to China’s “zero COVID” lockdowns, and potential delisting of Chinese American Depositary Receipts (ADRs) from the U.S. stock market. Encouragingly, most of those headwinds have now abated. In late 2022, China lifted its COVID restrictions, allowing the economy to fully reopen. The U.S. and China agreed on a compromise solution regarding inspection of Chinese companies’ accounting records, removing the potential delisting risk of Chinese ADRs. The Chinese central government also softened its tone with regards to regulatory restrictions on private businesses. Unlike the U.S., where the Federal Reserve is raising interest rates to slow down the economy, China is intently focused on stimulating economic growth in 2023. During the latter half of the review period, we saw some stabilization of the Chinese healthcare indexes to reflect the more favorable macro backdrop. Our expectation is that Chinese biotech shares should rise from current levels now that the macro headwinds have abated. While the state of U.S./China relations remains difficult, we think U.S. trade restrictions will continue to be focused on industries directly relevant to security and national defense rather than healthcare. Additionally, the primary market for our Chinese biotech positions is the Chinese domestic market, not the U.S. market.

EMERGING BIOTECH VALUATIONS STILL AT 20-YEAR LOWS

Our confidence in a recovery of small and mid cap biotech really stems from the observation that absolute and relative valuations in that segment remain at 20-year lows.

As we have noted in the past, one proxy commonly used to track performance of small and mid cap biotech is the XBI, an equal weighted index of biotech companies created in 2006. About 50% of this index consists of small cap names. If one plots the relative performance of the XBI versus the S&P 500 (shown in Figure 4 on page 13 of the Annual Report), one can see that since inception, the XBI has outperformed the S&P 500, indicating that emerging biotech has historically been a sector offering better returns than the broader market. Over the past 15 years however, there have been short periods when the XBI has underperformed the S&P 500, shown by the red circles. Typically, these drawdown periods result in underperformance versus the S&P 500 of 30-45%. The most recent relative drawdown was 73%, making it the longest and largest drawdown of the XBI on both an absolute and relative basis. Prior drawdowns have been followed by periods of significant outperformance of the XBI versus the S&P 500, denoted by the green arrows on the graph, which usually results in the biotech index reclaiming prior outperformance highs. Encouragingly, a recovery from the recent relative drawdown started to take place in the second half of 2022, only to be cut short by the banking crisis in March. Our view is that the bank-related retracement is just a temporary setback in an eventual recovery over the next several months.

On an absolute valuation basis, a significant number of biotech companies are now trading at market caps below the net cash on their balance sheets. In other words, the market has assigned a negative value to these listed enterprises when the value of their cash holdings is excluded. As shown in Figures 5 and 6 (on page 14 of the Annual Report), we estimate about 25% of the biotech universe, representing approximately 120 companies, is now trading at negative enterprise values as of 31 March 2023. The graphs show how unprecedented these valuations are in historical context. We have never seen valuations remotely approaching these levels in over 20 years, even in previous major market drawdowns like the Great Financial Crisis or the Dot Com Bust.

The compelling absolute and relative valuations of emerging biotech have led us to continue maintaining our small cap biotech overweighting in the portfolio. While a recovery has taken longer to materialize than we had anticipated, we think that it is just a matter of time before the sector rerates to historical norms. Possible catalysts to trigger such a revaluation include a possible pause in interest rate hikes by the

Fed as early as mid-2023, with some investors now anticipating interest rate cuts in the second half of 2023. M&A activity and positive clinical developments should also help aid a recovery.

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Managers, Worldwide Healthcare Trust – 7 June 2023

Whilst healthcare stocks in general may have struggled this year given the see-saw of macro headwinds, there were a number of positive sector developments to highlight. First, some investors expressed angst over a slowdown of new drug approvals at the FDA. However, entering 2023, disrupted work schedules because of the coronavirus have dwindled and most recently, FDA inspectors returned to China for the first time in years which is encouraging (source: Washington Analysis).

A significant number of complete response letters and extended user fee dates had been issued by the agency due to the inability to complete the inspections, so this is a welcome relief for the industry. More importantly, despite some delays, the past six years have been the most productive in industry history, with almost 300 new product approvals during that span. The FDA has kept pace so far in 2023, with 13 additional approvals in the first three months of the calendar year (source: fda.gov).

Perhaps the largest sector development that has occurred during this period is new legislation that was approved by the U.S. Senate and signed into law in July 2022 – the Inflation Reduction Act of 2022 (“IRA”) – which settled concerns about prescription drug price reform. The threat of drug price reform in the U.S. has been a persistent source of uncertainty and negative sentiment, an overhang for the biopharmaceutical sector for decades, but particularly over the past two years since President Biden took office. The IRA was modest in scope and included a mix of positive and negative factors for the biopharmaceutical industry. Overall, we view the IRA as very manageable for the biopharmaceutical sector, with limited impact on profits into the end of the decade, and perhaps the issue of drug price reform can now begin to dissipate as an overhang on the sector.

The Company has taken advantage of accelerating M&A activity within the biotechnology space and we expect that trend to continue. With the insatiable need for large capitalisation companies to continue to fill their pipelines and replace revenues lost to patent expirations, this is a logical view. In fact, the pharmaceutical industry appears to be facing another “patent cliff”, starting in 2023 and inflecting in 2025. A number of major blockbusters will be losing their exclusivity and sales will erode substantially, leaving major gaps in revenues and earnings for a number of companies. With the historic small-mid-capitalisation biotechnology stock sell-off and large capitalisation executives talking up the need to execute deals, a plethora of transactions began in earnest, inflecting in June 2022. The result for the financial year was a near doubling in the number of biotechnology transactions to 30 and near quadrupling of the value of deals, to U.S.$113 billion. This has been a real rallying point for the industry, especially in biotechnology, and as we have seen in the past, M&A can move the entire sector higher and we have finally seen these stocks move off the bottom after experiencing the largest and longest drawdown in the history of the “XBI” (the biotech ETF).

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Debt

(compare renewable energy funds **here**)

Claire Whittet, chair, TwentyFour Select Monthly Income Fund – 7 June 2023

Looking forward to the rest of 2023, the themes permeating the market in 2022 continue to remain front of mind. Whilst market commentary suggests that we are close to the peak in interest rates, inflation across the UK and Europe, in particular, remains persistently above targets - with headline inflation in the UK only recently moving below 10% and core inflation in Europe still at record highs.

The Portfolio Manager expects economic fundamentals to weaken to a level commensurate with a mild recession, where unemployment and default rates rise – but to lower levels than seen in previous recessionary cycles, given both strong consumer and corporate balance sheets and a banking sector that remains open to lend to their corporate partners. Indeed, the default rate forecast over the next 12 months remains broadly consistent with longer term averages in both the US and Europe, even in a mild recession scenario, and it is worth noting that the Company has historically seen a much lower default rate than the market, a trend which the Portfolio Manager expects to continue.

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Farming and forestry

Richard Davidson, chair, Foresight Sustain. Forestry – 13 June

Despite sharp rises in interest rates and falling equity and real estate prices in 2022, our Managers have observed good evidence that indicates that the investment market for forestry assets and FSF's strategy will remain resilient. Underpinning this resilience are three characteristics. First, UK forest owners tend not to use structural leverage, meaning forest property prices are to some extent insulated from rising interest rates. Second, UK forest owners enjoy a five to ten year harvesting window on mature trees, meaning less impact from short-term timber price volatility. Proactive decisions can be made to not cut and instead leave maturing timber "on-the-stump" to add biomass and value during times of softer timber prices. Finally, the global sustainable timber supply deficit is widely expected to continue to expand. Whilst the UK is waking up to the importance of increased domestic timber security, trees, by their nature, will take 35-40 years until they will reach harvesting maturity.

In the short term, domestic demand for sustainable timber is expected to remain subdued. Domestic construction demand is forecast by the Construction Products Association ("**CPA**") to be down by c.5% in 2023, versus 2022, impacted by a combination of high inflation and high interest rates.

On the supply side, with most storm damaged timber now processed through supply chains, inventories are back to more normal levels. Over the long term, the uneven age profile of commercial forests in the UK means that annual softwood supply is forecast by Forest Research to peak in the 2030s and then decline by c.45% by

2050. Over the long term, in the UK, demand for sustainable timber is expected to almost double by 2050, according to industry body Confor.

It also remains important to note that the UK imports c.80% of all timber consumed, and of these imports 63% are softwood, so international dynamics remain an important factor in determining UK conditions. The ongoing Russian war in Ukraine means all timber originating from Ukraine, Russia and Belarus is deemed conflict timber and cannot be certified as sustainable for the duration of the conflict. Pre-invasion, Russia, Belarus and Ukraine accounted for c.20% of the global timber trade.

The demand outlook internationally has improved during the reporting period. The Inflation Reduction Act ("**IRA**") in the US is expected to materially increase US timber demand. There is early anecdotal evidence that increasing volumes of European timber are being exported to the US to fulfil this growing demand. The demand outlook in China has also improved following the lifting of zero-Covid policies and the implementation of a substantial rescue plan for its indebted property developers.

Finally, with the rest of Europe enjoying a slightly softer landing than the UK, the demand for sustainable timber has been slightly more resilient in Europe than in the UK. However, the long-term demand outlook for sustainable timber in both the UK and Europe remains positive and underpinned by the prevailing decarbonisation agenda.

Infrastructure

(compare infrastructure funds **here**)

Shonaid Jemmett-Page, chairman, Cordiant Digital Infrastructure – 22 June 2023

Growth in data traffic continues to accelerate globally due to growing adoption and demand from multiple sectors. This trend is agnostic to any one sector's behaviour because it is fuelled by growing demand from many industry segments.

Interconnect data centres act as crossroads for digital data traffic movement and edge data centres bring the digital traffic closer to the end customer. Improved end-user experience and a growing need for data traffic optimisation are resulting in growth in both these markets.

Generative AI has the potential to drive a surge in demand for higher capacity data centre space and traffic on fibre networks. In addition, for data centres, increasing use of AI is expected to translate to higher kilowatt requirements from customers and increases in revenues.

The Investment Manager also believes that AI is likely to be a positive influence for the broadcast market. Broadcasters can use AI analytics to gain granular insight into their audience faster and more effectively than was the case historically. Better understanding of viewer demographics will come from probabilistic data modelling which will be used for targeting advertising, leading to an improved return on investment for rand owners and higher revenues for the broadcasters. In turn this strengthens the market for TV channels on digital terrestrial TV, which benefits the Company's platforms.

It seems likely that AI serves ultimately to enhance the end viewer connections and stickiness for media content companies, either in broadcast or broadband media.

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Andrew Didham, chairman, GCP Infrastructure - 20 June 2023

The UK energy market is emerging from several years of unusual volatility. The reduction in economic activity as a result of the Covid-19 pandemic led to lower power prices; then in 2021 as the economy was recovering, a combination of below-average wind resources, maintenance of, and reduced output from, the French nuclear fleet and lower rainfall impacting hydro resources, prices started to rise. In 2022, with the Russian invasion of Ukraine, the sanctions and issues with gas exports from Russia led to significant price increases and volatility in both short and long-term price expectations.

In the period, short-term prices have fallen back below 2022 prices, and the UK energy market forward curves have been lower despite market shocks, such as OPEC+ announcing that it intends to cut output. Whilst long-term price forecasts have historically been on a downward trajectory, the Investment Adviser has seen a structural shift, increasing current long-term electricity price expectations.

The long-term increase in prices can be explained by the increased focus on electricity security resulting from the Russian invasion of Ukraine. To reduce reliance on gas from Russia, the UK, and other European countries, will need to rely on imports of liquefied natural gas ("LNG"). In Germany, there has already been significant investment in its ability to import LNG, and this investment is set to continue. LNG tends to be more expensive (given costs to liquefy and regasify after transport) than piped gas and hence this will naturally increase long-term power costs.

The drive for energy security, including increased renewable energy, will require significant investment across Europe and this is also expected to increase long-term costs. Furthermore, electricity demand is expected to increase, driven by the decarbonisation of transport and heating amongst other factors.

The UK Government's 2023 Green Finance Strategy sets out how it intends to mobilise green investment. It highlights that the transition to a low-carbon economy is not only an environmental imperative but a growth opportunity for the UK. With an estimated £50-£60 billion of capital investment required each year to deliver the UK's net zero ambitions, there is significant opportunity for private sector capital investment. This includes strategies to deliver up to 50 GW of new offshore wind capacity by 2030, up to 70 GW of solar capacity by 2035 and up to 10 GW of low-carbon hydrogen production capacity by 2030.

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Private equity and growth capital

Managers, Chrysalis Investments - 27 June 2023

While the intensity of investor concerns over rising interest rates and growth valuations appears to have diminished to a degree since the end of 2022, "animal spirits" still appear to be absent from global markets, with the US yield curve remaining inverted and the short end moving higher over the last few months. Whilst the impact on the Chrysalis portfolio was negligible, the collapse of Silicon Valley Bank and wider concerns across the banking sector, have also had an impact on sentiment.

The hiatus in stock issuance, and in particular IPOs, is marked. In the UK, only 27 IPOs occurred over the year to March 2023.

Given the first quarter of 2023 was also weak, and the second quarter has not started well, the market is currently in the sixth quarter of anaemic issuance in the UK. By comparison, the GFC, a much more severe crisis, saw low issuance last for seven quarters. It is always difficult to "call the bottom", but the duration of this slowdown suggests we are nearer the end, rather than the beginning, of the normalisation process.

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Renewable Energy

(compare renewable energy funds **here**)

Managers, chairman, Harmony Energy Income Trust – 28 June 2023

The UK has a legally binding target to achieve "net zero" by 2050 and has enshrined in law a target to reduce emissions by 78 per cent by 2035 compared to 1990 levels. The UK's greenhouse gas ("GHG") emissions fell by 49 per cent between 1990 and 2022, with the shift from fossil fuel-based energy to renewables playing an important role in delivering emissions reductions. UK renewable generation, primarily wind and solar, has more than quadrupled over the past 10 years, with wind farms contributing a record 26.8 per cent of the country's electricity in 2022. This growth has been supported by government subsidies and support schemes, such as the Feed-In Tariff, the Contracts for Difference ("CfD") scheme and the Renewable Obligation but has also been driven by rapid reductions in cost that have allowed some renewable energy projects to start competing in a subsidy-free environment. National Grid ESO predicts that by 2050 the GB network will include a minimum of 150 GW of renewables (Falling Short Scenario) and a possible maximum of 249 GW (Consumer Transformation Scenario).

Renewables are known as "intermittent" generation assets as their output relies on prevailing weather conditions and can therefore be difficult to forecast accurately ahead of delivery. Supply and demand of electricity must be balanced and matched in real-time in order to maintain the stability of the electricity system. Responsibility for this balancing lies with National Grid ESO as the system operator. This role has become more challenging and costly as the proportion of intermittent generation on the electricity system has increased.

In response to the growing costs and complexity of balancing the system, National Grid ESO has developed (and is continuing to develop) new processes, systems, and service products to encourage new storage technologies, and in particular battery energy storage assets (BESS), to develop and participate. BESS provide important services that support the electricity system's safety and stability, while supporting the integration of more renewables on to the system and lowering the carbon intensity of the grid. BESS investments do not rely on government support and subsidies in the same manner as renewables. National Grid ESO predicts that, in order to keep pace with the growth of renewables, between 22 GW (Falling Short Scenario) and 50 GW+ (Leading the Way Scenario) of energy storage is required by 2050. As at the date of this report, there is currently c.5.4 GW of storage in GB, of which c.2.6 GW (48 per cent) constitutes utility-scale BESS.

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John Roberts, chair, Triple Point Energy Transition – 19 June 2023

The energy market is undergoing a seismic transformation, driven by the urgent need for decarbonisation and a growing emphasis on energy security and independence. The Company's broader investment mandate positions it for success in this rapidly evolving landscape by diversifying its portfolio across three thematic areas: distributed energy generation, onsite energy generation and lower carbon consumption, and energy storage and distribution. This approach not only mitigates risk and enhances resilience but also supports the Net Zero pathway, presenting a favourable outlook for the Company's investment prospects.

The Company is well-positioned to capitalise on the immense potential arising from the ambitious renewable energy targets and various legislative initiatives in the UK and EU markets, such as Powering Up Britain and REPowerEU. These programmes aim to unlock a vast amount of investments and create a favourable environment for the growth of clean energy technologies, opening up a market worth $5.3 trillion across Europe.

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Kevin Lyon, chairman, NextEnergy Solar Fund – 16 June 2023

Despite many ongoing challenges, the current environment presents a very attractive backdrop for investment in clean energy infrastructure. Increased deployment of renewables is integral to energy independence and security in the UK and globally, the benefits of which are reduced reliance on volatile global power markets and, in turn, reduced costs for consumers. As renewable energy generation capacity increases on the grid there is need for battery storage to bring about stability and flexibility and the company has taken important steps in this space over the period.

Governments around the world continue to drive forward their net zero targets and the production of renewable energy is playing a key role in helping to achieve these ambitions. Indeed, strategies recently published by the UK Government, such as Powering Up Britain and the Green Finance Strategy, clearly outline its goals to support deployment of solar and energy storage capacity. Furthermore, in line with the Independent Review of Net Zero recommendations, the Government plans to develop and publish a solar roadmap to 2035 to support the significant increase in deployment needed to achieve its 70GW ambition. NESF is in a strong position to contribute to these strategies, providing an alternative to fossil fuels, and capitalise on the opportunities associated with the energy transition in the UK and across Europe.

Juliet Davenport, chair, Atrato Onsite Energy – 12 June 2023

Wholesale electricity prices remained volatile during the Period as geopolitical factors and weather conditions continued to impact the market. The average monthly price volatility for the day-ahead baseload price in Q4 2022 was more than 2.5 times the long-term average volatility for the fourth quarter (from 2014 to 2020 inclusive).

Although average prices in March 2023 fell to their lowest level since August 2021, they remain elevated compared to long-term norms, being 2.75 times the average value for March from 2014 to 2020 (inclusive).

Against this backdrop, energy costs remain a top risk factor for the majority of UK businesses, with wholesale costs and market volatility constituting the top two subcategories of concern for businesses in a 2023 survey. Almost three quarters of businesses surveyed expect costs to continue rising over the next 12 months, despite some continued protection in the form of the revised Energy Bills Discount Scheme (the "EBDS") which replaced the more generous Energy Bill Relief Scheme from 1 April 2023. The EBDS provides relief of up to £19.61 per MWh when wholesale costs exceed £302 per MWh, meaning that the threshold for relief remains significantly higher than the levelized cost of generation for solar energy in the UK.

Alongside the cost savings and price certainty, there has been continued growth in demand for corporate decarbonisation. The Science Based Targets Initiative ("SBTi") now reports 829 UK companies taking action, of which 430 have had their targets independently validated by the SBTi.

The UK government has recognised solar energy's role as a cost-effective contributor to a net zero energy mix and stated an ambition to deploy 70GW of solar generation by 2035, a significant increase on the existing 14GW of installed capacity. In support of this, a solar roadmap will be published in 2024, setting out a step-by-step deployment trajectory, and a dedicated taskforce made up of industry and government members is to be established to drive forward both rooftop and ground-mounted capacity. A consultation is already underway to simplify planning processes and expand permitted development rights for large commercial rooftop solar projects and solar car-port structures. Constraints imposed by the grid connection process are also due to be addressed, with the government publishing an action plan this summer and reduced connection application costs having come into force from 1 April 2023.

Property

(compare UK property funds **here, here, here, here, here, here** and **here**)

Richard Moffitt, chief executive, Urban Logistics REIT:

The macroeconomic and geo-political picture for 2023 and beyond continues to evolve. Given the re-pricing of real estate assets and land values in 2022, we believe that the equilibrium level where buyers and vendors will trade has been found more quickly than witnessed in previous cycles. Investors are already returning to the market, attracted by re-based higher yields, rental value growth and the long-term drivers of the logistics sector.

As the take-up statistics for the last twelve months have borne out, an emphasis on resilient supply chains continue to be a key focus of our occupier base, coupled with the fact that e-commerce remains a fundamental and growing part of the economy. This provides a sound footing to our business model of last-touch, mid-sized logistics assets, let to financially resilient tenants.

The market continues to be characterised by low vacancy rates in the occupational space, providing confidence to investors looking to deploy capital. Whilst we are conscious of the weakening consumer environment (exacerbated by the cost of living crisis) and the rising occupational costs of labour and business rates, the fundamentals of the logistics sector continue to be attractive.

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Neil Kirton, chairman, Warehouse REIT:

There are clear signs that the investment market is stabilising and investors are returning, reflecting the very favourable supply-demand dynamics in our markets. However, as an industry, we are highly sensitive to the future path of interest rates and the outlook remains uncertain.

In this context, the ability to drive growth organically is key to delivering returns. Occupier demand for space remains robust and our sector continues to benefit from strong tailwinds, including the growth of online retail and heightened focus on supply chain resilience. In addition, our strong bias towards multi-let space in economically relevant locations means we are well placed to capture demand and drive rents. Selected development opportunities provide further upside and we will commit to these as and when the time is right.

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Simon Lee, chief executive, LXi REIT:

The government and Bank of England believe they have more certainty over inflation over the near term, with inflation expected to return to more normal levels by the end of the year.

The impact of inflation for the group's rental income is positive, given the portfolio's rent review linkage to UK inflation (26% RPI, 38% CPI). We are, however, cognisant of the potential impact that current levels of inflation could have on the wider economy. This may also be an impact on the prospects of our tenant operators but they can be managed by the rent review caps to the mutual benefit of the company and its tenants.

The interest rate rises used to combat inflation have meant that property values in the UK have been impacted as was shown in the group's valuation yield shifting to 5.4%. There are signs that the bottom of this value cycle has been met with the CBRE monthly index shows a rise (0.6%) in capital values for first time since the repricing last year.

We see a number of opportunities such as assets coming out of open-ended funds due to redemptions, a number of corporate bonds are coming to maturity meaning they will need to find alternative sources of funding such as sale and leasebacks. The most significant opportunity we see is further M&A activity in the REIT market. There are a large number of mid-market generalist REITs which do not have the same access to capital, liquidity and low cost base which LXI does. We believe we have shown the material tangible benefits of which a merger can achieve with the SIR plc.

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Alastair Hughes, chairman, Schroder REIT:

The principal cause of this correction is more persistent core inflation, driven by high energy and food prices, leading to increasing interest rates. Tighter fiscal and monetary conditions, combined with a withdrawal of pandemic related business support programmes, have led to a rise in business insolvencies and a slowdown in consumer spending. In real estate markets, higher interest rates have impeded debt-backed buyers and increased refinance risk for many borrowers, with a related fall in equity and bond prices leaving some institutions over-allocated to real estate. This environment has led to weaker sentiment and a sharp fall in transaction volumes.

The resultant decline in values has increased average real estate net initial yields from 3.8% in June 2022 to 4.7% today, the highest level since June 2020, with our portfolio now yielding 5.8%. As expected, lower yielding, higher growth real estate sectors such as South East and London industrial have been most adversely impacted by this rerating, resulting in a reversal in the unprecedented polarisation of returns over recent years. Higher yielding sectors - such as retail warehousing, and offices in stronger regional centres - have been less adversely impacted, leading to a convergence in returns across the main sectors. Against this backdrop, our well diversified portfolio has outperformed the Benchmark due to the active management of the higher yielding, regional industrial estates, as well as higher-yielding retail warehousing and offices in stronger regional centres.

Occupational markets have, so far, remained more resilient, with average nominal rental value growth for UK real estate of 2.5% per annum since June 2022. Although below current inflation levels, there remains a strong positive long-term correlation between rental growth rates and inflation, with sectors benefiting from structural demand drivers and lower vacancy rates delivering rental growth well above the long-term average of approximately 0.9%. For example, in contrast with the sharp decline in capital values, average industrial rental values have increased by 5.9% since June 2022.

There are initial signs that the investment market is now stabilising, with a capital value decline from our underlying portfolio of -0.5% over the quarter to March 2023 (Benchmark: -1.3%), contrasting with -11.9% over the quarter to December (Benchmark: -13.2%). The extent of any subsequent recovery will depend on falling inflation, with the Bank of England currently forecasting a return to its target rate in 2024. In this seemingly benign scenario, interest rates should fall, but probably to a higher equilibrium rate of around 3%, above the ultra-low levels of the recent past. A gap of approximately 2% between property yields and 10-year gilts is approaching the long-term average for fair value, which, combined with a more a stable political backdrop and currency, should attract domestic and international capital flows back to the sector.

Looking forward, long term structural trends such as urbanisation, technological change, demographics and sustainability should continue to drive returns, with multi-let industrial estates, retail warehousing, certain London office sub-markets and some alternative sectors expected to outperform. These sectors should also benefit from limited new development. This contrasts with secondary office and weaker retail assets, where obsolescence, higher vacancy and lower levels of occupational demand will negatively impact returns.

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Richard Shepherd-Cross, manager, Custodian Property Income REIT:

Despite investment market volatility during 2022, in many ways the real estate market is in a much better place than it has been for the last 18 months. Rent collection levels are very strong, COVID-19 restrictions appear to be behind us and the impact of COVID-19 on tenants' businesses is largely resolved. The economy has, thus far, narrowly avoided recession but even in a slowdown we are not faced with an over-supply of real estate and rising vacancy rates which are so often associated with the property market in recession.

In the 12 months to 31 March 2023 the UK commercial property market saw valuations decline by 17% with the bulk of the rerating in the quarter to December 2023. These valuation decreases were primarily due to changes in the macro-economic environment including heightened uncertainty from rising inflation, slowing economic growth, the energy crisis, increasing interest rates, stresses in supply chains, constraints in the labour market and low consumer spending against the backdrop of seeking to mitigate the impact of climate change. With valuations appearing to have stabilised it is possible to see the rapid correction due to the new interest rate environment as strongly positive for the market, maintaining liquidity and providing future acquisition opportunities.

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Laura Elkin, manager, AEW UK REIT:

Despite some major political and economic volatility, the UK economy has performed better than expected since September 2022. UK recession has been avoided to date with GDP recording modest growth of 0.2% during April following 0.1% growth in the first quarter. The prospect of lower household energy bills from July and the impact of the fiscal loosening announced in March's Budget mean that recovery is expected to gain traction in H2 2023. Inflation is expected to resume its downward trajectory, albeit slowly.

The UK's labour market has remained resilient but, with a slowdown in job creation seen since the fourth quarter of 2022, the unemployment rate is projected to increase before the end of 2023, adding to the cost of living pressure already being acutely felt by many consumers.

As financial markets take stock of recent uncertainties, including the instability and failure of various US based financial institutions, we expect the lending environment to remain cautious.

Following the swift repricing of UK commercial property in the second half of 2022 and an improving macro-economic outlook, UK property is expected to offer healthy return prospects over coming periods. Consensus forecasts show an expected return to positive rental growth across all major market sectors by 2025 and all UK property total returns to average 5.6% per annum over the next five years (2023-2027).

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Rob Whiteman, chairman, Residential Secure Income:

The UK's structural housing shortfall continues and most of the population lives in areas where home purchase is unaffordable for average earners, with an estimated need for £34bn of annual investment over the next decade to begin addressing the shortfall. Persistent inflation, rising mortgage rates and the consistent demand for a permanent home have increased demand for shared ownership as the most affordable homeownership option (particularly in light of the Help to Buy programme's end in March 2023). The UK population demographic is rapidly aging and social isolation can have a material impact on the health of the elderly, driving demand for independent retirement accommodation.

Housing associations, who have historically been the primary investors in affordable housing, are now dealing with rent caps on their social and affordable rent portfolios in addition to allocating c.£10bn for fire safety and c.£25bn to upgrade the energy efficiency of their social rented stock by 2030. These financial pressures impact their ability to continue to fund their 43,000 homes per year development programmes, with many now looking to bring in partners to acquire some of their existing 200,000 shared ownership homes. This is continuing to drive demand and opportunity for further long-term investment into the sector - both to fund new homes and acquire existing shared ownership portfolios providing capital to housing associations to invest back into their social rented stock.

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Sir Julian Berney, chairman, Schroder European REIT:

Confidence surrounding the European economy is improving with recessionary fears diminishing. Expectations are for economic growth to be modest for some time, as governments continue to tighten economic policies to reduce inflation and preserve financial stability. As a result, the pricing of real estate will continue to be challenging and exacerbated by rising debt costs, sustainability concerns and corporates post-COVID optimum occupational intentions. Banks are becoming much more discerning on who they lend to and the type of real estate they wish to lend on. Their clear preference to focus on better quality assets that meet sustainability benchmarks will continue. As a result, we anticipate further valuation falls as investors face refinancing dilemmas, sustainability risks and equity investors re-price their cost of capital.

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